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Supreme Court, U.S.
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In the

Supreme Court of the United States

OCTOBER TERM, 1979

ANTHONY COLAO, ROY V. JOHNSON, MORRIS I. GINSBURG, PAUL J. MILLER, WILLIAM A. F. SMITH, GEORGE R. CABLE and HAROLD J. SEXTON,
Petitioners,

vs.

MERIT INSURANCE COMPANY, INC., an Illinois Corporation,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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Petitioners,

vs.

MERIT INSURANCE COMPANY, INC., an Illinois Corporation,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Petitioners pray that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit entered in the above-entitled case on August 7, 1979 (Petition for Rehearing denied on November 6, 1979).

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit (A. 1a-20a) is reported in 603 F. 2d 654. The opinion of the United States District Court for the Northern District of Illinois, Eastern Division (A. 21a-35a) was not reported.

JURISDICTION

The judgment of the Court of Appeals was entered on August 7, 1979. Rehearing was denied on November 6, 1979, and this Petition for Writ of Certiorari was filed within ninety days of that date. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. May a Court of Appeals in a diversity case, under the guise of interpreting the Federal Rules of Civil Procedure, create a substantive right not recognized under State law, in contradiction to this Court's decision in *Erie R. Co.* v. *Tompkins*?

2. May a Court of Appeals in a diversity case decide important State questions in a way in conflict with applicable state law: (a) by creating a civil liability of accountants not authorized by State law; and, (2) by reversing a directed verdict which was mandated by State law?

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

(a) Federal Judiciary Act of 1789, Section 4, 28 U.S.C. § 725:[1]

> "The laws of the several States, except where the Constitution, Treaties or Statutes of the United States shall otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States in cases where they apply."

[1] The words "civil actions" were substituted in the 1948 recodification of Title 28 of the United States Code. See 28 U.S.C. § 1652.

(b) Act of June 19, 1934, Ch. 651, Sec. 1, 48 Stat. 1064:[2]

> ". . . the Supreme Court of the United States shall have the power to prescribe, by general rules, for the district courts of the United States and for the courts of the District of Columbia, the forms of process, writs, pleadings, and motions, and the practice and procedure in civil actions at law. Said rules shall neither abridge, enlarge, nor modify the substantive rights of any litigant."

(c) Federal Rule of Civil Procedure 8(c), 28 U.S.C.:

> "(c) Affirmative Defenses. In pleading to a preceding pleading, a party shall set forth affirmatively accord and satisfaction, arbitration and award, assumption of risk, contributory negligence, discharge in bankruptcy, duress, estoppel, failure of consideration, fraud, illegality, injury by fellow servant, laches, license, payment, release, res judicata, statute of frauds, statute of limitations, waiver, and any other matter constituting an avoidance or affirmative defense. When a party has mistakenly designated a defense as a counterclaim or a counterclaim as a defense, the court on terms, if justice so requires, shall treat the pleading as if there had been a proper designation."

STATEMENT OF THE CASE[3]

Respondent, Merit Insurance Company, which specialized in writing substandard automobile insurance, en-

[2] Recodified in amended form. See 28 U.S.C. § 2072.

[3] It is difficult to make a succinct statement of a case which took four months of trial time, particularly when petitioners do not agree with certain of the facts as stated in the majority opinion of the Court of Appeals. Space limitations do not provide for a delineation of these differences, however, the essential facts have been set forth above and brief additional factual references are incorporated below where relevant to the reasons for granting the Writ of Certiorari.

tered into a reinsurance contract in 1972 with Leatherby Insurance Company and Leonard Lebowitz, President of General Auto Placement Company, an insurance agency. Under the agreement, respondent agreed to undertake the risks previously written by Leatherby in return for unearned policy premiums and monies Leatherby had reserved on these risks. Leatherby and Lebowitz concealed from respondent the fact that one million dollars in additional reserves had been set aside and, therefore, it received one million dollars less than was provided for under the contract.

Respondent commenced an action against Leatherby, Lebowitz and petitioners herein who had rendered an opinion upon the financial statements of Lebowitz' company. These financial statements covered a period of time ending almost two years before respondent entered into the agreement from which it claimed to have sustained its alleged losses. Respondent dismissed Lebowitz from the action in exchange for his testimony, and the claims against Leatherby were submitted to arbitration which is currently proceeding.

Suit was filed in the district court on the basis of diversity of citizenship and the case against petitioners was based on several counts, only two of which are pertinent here. The count in negligence was stricken before trial and the case proceeded only on the fraud count. After a lengthy trial, the district court directed a verdict for the petitioners.

The Court of Appeals for the Seventh Circuit, in a two-to-one decision, reversed the trial court and remanded the case for trial on both the issues of negligence and fraud.

REASONS FOR GRANTING THE WRIT OF CERTIORARI

I.

The Court Of Appeals In A Diversity Case, Under The Guise Of Interpreting The Federal Rules of Civil Procedure, Has Created A Substantive Right Not Recognized By State Law Which Is In Conflict With The Rule Of Law Set Down By This Court In Erie R. Co. v. Tompkins.[4]

Respondent's common law negligence action, which was dismissed by the district court, is fatally defective on its face under the substantive law of Illinois. Count I of the Third Amended Complaint is pleaded in common law negligence under Illinois law but does not contain an allegation that the plaintiff was in the exercise of ordinary care or, alternatively, that it was free from contributory negligence. In passing upon the point, the Seventh Circuit erroneously held:

> "*Illinois procedure* requires a plaintiff allege freedom from contributory negligence. The complaint contains no such allegations. But the allegation was unnecessary because under Fed. R. Civ. P. 8(c) *contributory negligence is an affirmative defense* which a defendant, not a plaintiff, must plead." (A. 10a, Emphasis added.)

It simply is not true that "Illinois procedure" requires a plaintiff to allege freedom from contributory negligence. By its ruling the Seventh Circuit has misstated the substantive common law of Illinois.

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[4] 304 U.S. 64 (1938).

Illinois is a jurisdiction that continues to require allegations of either the plaintiff's exercise of ordinary care or freedom from contributory negligence as "an essential part of the plaintiff's cause of action."[5] This requirement has nothing to do with rules relating to "defenses" because under Illinois law a plaintiff who fails to allege this required element will have his complaint dismissed even though the defendant pleads no defenses, *Corbett* v. *Devon Bank,* 12 Ill. App. 3d 559, 299 N.E. 2d 521 (Ill. App. 1973), and will not have anything on which to present proof. *Day* v. *Talcott,* 361 Ill. 437, 198 N.E. 339 (Ill. Sup. 1935). Thus, it is clear that under Illinois law that which must be alleged in a negligence complaint is "substantive" and not "procedural" law, *Stephens* v. *Illinois Central R. Co.,* 256 Ill. App. 111 (Ill. App. 1930), and it has been long held by the courts of this Circuit that the pleading of absence of contributory negligence is an ". . . essential part of plaintiff's cause of action by the substantive law of Illinois" and that "Rule 8(c) does not authorize its omission" from the pleading. *Francis* v. *Humphrey,* 25 F. Supp. 1, 5 (E.D. Ill. 1938).

In the case of *Palmer* v. *Hoffman,* 318 U.S. 109 (1943), this Court declared that:

> "The question of the burden of *establishing* contributory negligence is a quesion of local law which federal courts in diversity of citizenship cases must apply."

318 U.S. 109, 117. (Cites omitted.) Neither in *Palmer,* nor in any subsequent decision, has this Court ever held that the federal pleading rules may override substantive State

[5] Prosser, Law of Tort, 3d Ed. (1964), Ch. 12, § 64, at 426.

law and create a cause of action not recognized under State law.

In *Erie, supra,* this Court specifically held that a federal court sitting in diversity must follow the local substantive law so that no different result would obtain when a claim or cause of action based on state law is filed in a federal court. Petitioners do not base their petition solely upon the fact that the outcome of this case would have been determined differently in a State court, which reasoning this Court has rejected as not being the sole criterion for determining violations of the *Erie* doctrine.[6] Petitioners base this petition also upon the fact that the ruling of the Seventh Circuit herein does create a substantial difference in the character as well as the result in another trial of this case.

In a subsequent opinion, *Guaranty Trust Co.* v. *York,* 326 U.S. 99 (1945), this Court summarized its holding in *Erie*:

> "Erie R. Co. v. Tompkins was not an endeavor to formulate scientific legal terminology. It expressed a policy that touches vitally the proper distribution of judicial power between State and federal courts. In essence, the intent of that decision was to insure that, in all cases where a federal court is exercising jurisdiction solely because of the diversity of citizenship of the parties, the outcome of the litigation in the federal court should be substantially the same, so far as legal rules determine the outcome of a litigation, as it would be if tried in a State court. The nub of the policy that underlies Erie R. Co. v. Tompkins is that for the same transaction the accident of a suit by a non-resident litigant in a federal court instead of in a State court a block away should not lead to a substantially different result." (326 U.S. at 109)

[6] *Hanna* v. *Plumer,* 380 U.S. 460, 468, fn. 9 (1965).

In *Guaranty*, this Court also stated that a state rule of decision which:

> ". . . would completely bar recovery if brought in a State court, bears on a State-created right vitally and not merely formally or negligibly. As to consequences that so intimately affect recovery or non-recovery, a federal court in a diversity case should follow State law." (326 U.S. at 110)

This Court, applying *Guaranty*, held in *Bernhardt* v. *Polygraphic Co.*, 350 U.S. 198 (1956) that:

> "The federal court enforces the state-created right by rules of procedure which it has acquired from the Federal Government and which therefore are not identical with those of the state courts. Yet in spite of that difference in procedure, the federal court, enforcing a state-created right in a diversity case is . . . 'only another court of the State' . . . and therefore may not 'substantially affect the enforcement of a right as given by the State.'" (350 U.S. at 203)

It is clear from this Court's most recent decisions as cited above, that this Illinois requirement for stating a cause of action in negligence is a matter of substantive law (*Erie*) since it "would completely bar recovery if brought in a State Court" (*Guaranty*); a requirement which, if not enforced by the federal courts, would "substantially affect the enforcement of the right as given by the State" (*Bernhardt*).

Petitioners are not unmindful of the fact that "the Erie rule has never been invoked to void a Federal Rule . . . ."[7] Petitioners do not seek to void Federal Rule 8 which does provide notice pleading that is adequate in the vast majority of federal diversity cases. However,

[7] *Hanna* v. *Plumer, supra*, 380 U.S. 460, 470 (1965).

petitioners do contend that the provisions of Rule 8(c) are procedural in nature and cannot supersede requirements of State substantive law. Unlike the situation confronted by this Court in *Hanna* wherein adherence to the state rule would only have resulted in altering the way in which process was served, the circumstances of the instant litigation are decidedly different, involving the very existence of respondent's alleged cause of action for negligence under Illinois common law. More to the point is the case of *Ragan* v. *Merchants Transfer & Warehouse Co.*, 337 U.S. 530 (1948), which involved the applicability of the Kansas statute of limitations in a federal diversity action. In *Ragan*, this Court found the cause of action barred by Kansas law despite the contradictory provision of Rule 4 of the Federal Rules of Civil Procedure, holding that:

> "Where local law qualifies or abridges it (the cause of action), the federal court must follow suit. Otherwise there is a different measure of the cause of action in one Court than in the other, and the principle of Erie R. Co. v. Tompkins is transgressed." (337 U.S. at 533—parenthetical added.)

Similarly, in *Woods* v. *Interstate Realty Company*, 337 U.S. 535 (1948), this Court found suit barred by operation of a state corporate registration requirement. To the same effect, see *Cohen* v. *Beneficial Industrial Loan Corp.*, 337 U.S. 541 (1948).

The Seventh Circuit's holding in this case that ". . . under Federal Rule of Civil Procedure 8(c), contributory negligence is an affirmative defense which a defendant, not a plaintiff, must plead" (A. 10a), not only violates the teachings of *Erie* and the authority of the Enabling

Act[8], but, also contradicts its own most recent decision concerning this section of Federal Rule 8. In *Sunstrand Corp.* v. *Standard Kollsman Industries, Inc.*, 488 F.2d 807, 813 (C.A. 7, 1973), the Seventh Circuit held that:

> ". . . to require a defendant to plead defenses enumerated under Rule 8(c) without reference to the burdens of proof thereon under State law is an inconsistent and unnecessarily mechanical interpretation of the federal rules."

The Seventh Circuit not only ignores the teachings of this Court in *Erie*, but has also determined Federal Rule 8(c) to be "irrelevant" as well.[9]

The failure of respondent to plead its exercise of due care was not inadvertent and emphasizes the important policy reasons underlying this Illinois requirement.

Respondent refused to plead, through four Complaints and in its motion for reconsideration of the dismissal of the negligence count at the close of all the evidence, that it was in the exercise of ordinary care. The reason for this intransigence is obvious from respondent's own trial evidence which conclusively demonstrated that it did not exercise ordinary care for its own financial interests. Although the majority never considered the record in this regard, the dissent noted respondent's failure to present any evidence which would support an allegation of due care (A. 20a).

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[8] 27 U.S.C. 2072.

[9] *Sundstrand Corp.* v. *Standard Kollsman Industries, Inc.*, 488 F.2d 807, 813 (C.A. 7, 1973).

Under the majority opinion, the character and result of this litigation will be substantially different from that which would obtain in an Illinois court. If allowed to stand, the majority will be granting respondent a cause of action not recognized by Illinois law and thereby permit it to pursue the rights of a litigant; to seek further discovery; to select a jury; and to force petitioners to incur the expense of another lengthy trial against charges of negligence when respondent has refused to allege, and has already proven it was not in, the exercise of ordinary care. Such a result could not obtain under Illinois law and is a clear violation of this Court's holding in *Erie R. Co.* v. *Tompkins*.

II.

The Court of Appeals Has Decided Important State Questions In A Way In Conflict With Applicable State Law By: (1) Creating A Civil Liability Of Accountants Not Authorized By Illinois Law; And, (2) By Reversing A Directed Verdict Mandated By State Law.

A. The Civil Liability Of Accountants Under The Common Law Is An Important Question.

The civil liability of accountants for negligence and fraud is a matter of grave importance to the accounting profession and to the business community which relies so heavily upon accountants. This Court recognized the importance of the civil liability of accountants under the federal securities law in its decision in *Hochfelder* v. *Ernst & Ernst*, 425 U.S. 185 (1976). The potential common law liability of accountants is of equal importance to a profession beset with protracted, expensive lawsuits which now seem to arise out of every financial default. Text writers have pointed out the deleterious

effects of such suits on the accounting profession and the business community in general.[10]

B. Liability Of Accountants To Third Persons For Negligence Has Not Been Recognized By The Illinois Courts.

As was noted above, respondent's attempt to state a cause of action in negligence against petitioners was fatally defective under the substantive law of Illinois.[11] However, aside from any questions concerning the need to plead due care under Illinois substantive law, the purported negligence count was otherwise fatally defective. Illinois courts have never considered, and accordingly have never authorized, an action against accountants by third parties for alleged negligence in the performance of audit functions. To the contrary, there exists every indication that, if confronted with this issue, the Illinois Supreme Court would not permit such an action.

The majority opinion of the Seventh Circuit based its reversal of the dismissal of the negligence charges against

[10] "Legal analysts in recent years have advocated an expanded auditors' liability to users of financial statements, with the dual objectives of improved disclosure to all investors and compensation of those who are injured. Unfortunately, it appears that the liability will not achieve either of its stated objectives. Instead, the liability will probably cause severe damage to the users of capital, the suppliers of that capital, the auditing profession, and the resource-allocating ability of the economy. Consequently, an expanded auditors' liability should be rejected, and the legal standard which permitted the accounting profession to develop the audit to today's level of assurance to investors should be reaffirmed." [46 Washington Law Review 675, 707 (1971)]

[11] Supra, I., pp. 5-11.

petitioners solely upon the case of *Rozny* v. *Marnul*, 43 Ill. 2d 54, 250 N.E. 2d 656 (Ill. Sup. 1969). That case simply involved the right of a subsequent purchaser of land to recover damages from the land surveyor who had admittedly made an erroneous survey for a prior owner. In imposing liability upon the surveyor, the Illinois Supreme Court commented:

> "We agree that the unknown and unlimited liability factor, as so ably stated by Mr. Justice Cardozo in the *Ultramares* case, is not to be lightly discounted. But we deal here with a defendant who has included in his inaccurate plat an 'absolute guarantee for accuracy.'" (43 Ill. 2d at 66, 250 N.E. 2d at 662)

In his dissenting opinion in this case, Judge Wood pointed out that three of the six factors relied upon by the Illinois Supreme Court in imposing liability on a surveyor were absent from the present case, and commented:

> "We find no indication in the Illinois law that persuades us that Illinois is ready to broaden the liability of accountants to encompass the situation in this case." (A. 19a)

There are relatively few cases decided under State law which decide the issue of the civil liability of accountants for negligence to third persons. Of these decisions the greater number hold that no such cause of action exists. Ironically, the Court of Appeals for the Seventh Circuit so found, apparently applying Illinois law in the *Hochfelder* case.[12]

The importance of this issue, taken together with the fact that the opinion of the Seventh Circuit is contrary

[12] *Hochfelder* v. *Ernst & Ernst*, 503 F.2d 1100 (C.A. 7, 1974), rev'd on other grounds 425 U.S. 185 (1976).

to the law of Illinois is a substantial reason for granting the Writ of Certiorari to the Court of Appeals for the Seventh Circuit.

C. The Court Of Appeals Decided The Issue Of An Accountant's Liability For Fraud In Conflict With Applicable State Law By Reversing A Directed Verdict Which Would Be Mandatory Under State Law.

The trial court entered a directed verdict for the petitioners after trial of the fraud issues, applying the test for directed verdict set forth by the Illinois Supreme Court:

> "... verdicts ought to be directed ... only in those cases in which all the evidence, when viewed in the aspect most favorable to the opponent, so overwhelmingly favors movant that no contrary verdict based on that evidence could ever stand."[13]

The Illinois Supreme Court in *Pedrick,* however, conditioned this test upon the following practical consideration:

> "But the presence of *some* evidence of a fact which, when, viewed alone may seem substantial, does not always, when viewed in the context of all of the evidence, retain such significance. As the light from a lighted candle in a dark room seems substantial but disappears when the lights are turned on, so may weak evidence fade when the proof is viewed as a whole. Constitutional guaranties are not impaired by direction of a verdict despite the presence of some slight evidence to the contrary (*Chamberlain,* Blume, 'Origin and Development of the Directed Verdict,' 48 Mich. L. Rev. 555, 576-7), for the right to a jury trial includes the right to a jury verdict only if there are factual disputes of some substance."[14]

[13] *Pedrick* v. *Peoria & Eastern R.R. Co.,* 37 Ill. 2d 494, 229 N.E. 2d 504 (Ill. Sup. 1967).

The Seventh Circuit agreed with all parties and the trial court that the *Pedrick* test was the proper test for measuring the propriety of a directed verdict. The Court of Appeals further acknowledged that under Illinois law allegations of fraud must be established by clear and convincing evidence, as recognized in its prior decisions affirming directed verdicts in fraud cases. *Mack* v. *Earle M. Jorgensen Co.,* 467 F.2d 1177 (C.A. 7, 1972); *Classic Bowl, Inc.* v. *AMF Pinspotters, Inc.,* 403 F.2d 463 (C.A. 7, 1968); *Hubert* v. *May,* 292 F.2d 239 (C.A. 7, 1961). While ostensibly applying the foregoing test of the propriety of a directed verdict, the Seventh Circuit reached the result opposite that mandated by Illinois law.

As noted by Judge Wood in his dissenting opinion:

> "At best the evidence tells the story of careless auditing by defendants and the devious intentions of Lebowitz and Leatherby. However, viewing all the evidence most favorably to plaintiff, a *prima facie* case of fraud against these defendants, even with a liberal use of inferences, was not established. Nothing short of pure speculation could save the plaintiff's case, and neither a jury nor ourselves may indulge in that." (A. 13a)

At least two indisputable points support Judge Wood's statement that a directed verdict in favor of petitioners was mandated under Illinois law.

As Judge Wood pointed out, Jerome Stern relied on the 1970 audit in June of 1972 when contracting with Lebo-

[14] *Pedrick* v. *Peoria & Eastern R.R. Co., supra,* 37 Ill. 2d 494, 504-05.

witz and again in October of 1972 when contracting with Leatherby and Lebowitz. The financial information prepared by petitioners was already sixteen months old when Stern first received it.

In this regard it is important to note that the majority opinion states: "Thus, it became a jury question as to whether Stern was justified in relying on the audit report which, in part at least, *indicated* General Auto's financial health in 1972." (A. 8a, Emphasis added.)

There is not a scintilla of evidentiary support for such a statement but, on the contrary, the evidence presented by respondent establishes precisely the contrary. Jerome Stern, respondent's president, testified that the audit in question for the year 1970 did not contain *any* information about General Auto's solvency, financial stability, profitability, loss reserves, or loss ratio in the year 1972. Respondent's evidence failed to establish that it had a right to rely upon the outmoded financial data at the time of the transactions giving rise to its loss. Additionally, respondent established by clear and convincing evidence that it had no such right to rely and therefore its case was deficient as a matter of law under Illinois decisions.

A second and independent basis which would also mandate the direction of a verdict was the absence of any evidence that any alleged errors in the audit in question caused any loss to respondent. Even as darkness fades in the presence of a lighted candle (*Pedrick*), so also does respondent's alleged claim of fraud completely disappear in the presence of the undisputed trial evidence which established conclusively that Merit's losses were due to the fraud of Lebowitz and Leatherby (as noted by Judge Wood above) which occurred almost two years after the

end of the audit period. The respondent's utter failure to establish by clear and convincing evidence any causal relationship between the alleged error in the audit and the loss claimed by it would also mandate a directed verdict under Illinois law.

Absent all other issues in the case, respondent not only failed to establish by clear and convincing evidence at least two essential elements of its alleged fraud claim, but, demonstrated beyond any doubt that no such claim existed under Illinois law. Accordingly, the district court correctly directed verdicts under Illinois law which the Seventh Circuit erroneously reversed.

CONCLUSION

As was observed by Justice Frankfurter in a special concurring opinion in the case of *Wilkerson* v. *McCarthy, et al.*, 336 U.S. 53, 65 (1949):

> "The easy but timid way out for a trial judge is to leave all cases tried to a jury for jury determination, but in so doing he fails in his duty to take a case from the jury when the evidence would not warrant a verdict by it. A timid judge, like a biased judge, is intrinsically a lawless judge."

After approximately four months of respondent's presentation of its so-called evidence, an experienced senior district court judge accepted this judicial responsibility and took this case from the jury. By its misapplication and erroneous interpretation of controlling legal principles, a majority of the panel of the Court of Appeals has rendered this lengthy judicial process a nullity.

For the reasons stated, the petitioners urge that a Writ of Certiorari should be granted to review the judgment and opinion of the Seventh Circuit Court of Appeals.

Respectfully submitted,

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Dated: January 25, 1980

APPENDIX

IN THE
UNITED STATES COURT OF APPEALS
For the Seventh Circuit

No. 78-1460

MERIT INSURANCE COMPANY, an Illinois corporation,
Plaintiff-Appellant,

v.

ANTHONY COLAO, et al.,
Defendants-Appellees.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.
No. 75 C 899—JULIUS J. HOFFMAN, *Judge.*

ARGUED DECEMBER 7, 1978—DECIDED AUGUST 7, 1979

Before SWYGERT, LAY* and WOOD, *Circuit Judges.*

SWYGERT, *Circuit Judge.* This diversity suit was started in 1975. The complaint, as amended, contained three counts. Count I alleged negligence; Count II—gross negligence; and Count III—fraud. At the pretrial stage, the district court dismissed the negligence counts for failure to state a claim and proceeded to try the

* The Honorable Donald P. Lay, Circuit Judge of the United States Court of Appeals for the Eighth Circuit, is sitting by designation.

fraud issue to a jury. For four months, November 1, 1977 to February 28, 1978, the plaintiff presented its case. On March 1, 1978 the trial judge granted motions for directed verdict in favor of all the defendants. From these adverse rulings, plaintiff appeals.

I

Merit is an Illinois casualty insurance company. It and its predecessor have been engaged in writing automobile liability insurance since 1968. The defendants are being sued individually and also as partners in Joseph Froggatt & Co., an accounting firm located in New Jersey but also operating in Philadelphia and New York City.

Two other entities are involved: General Auto Placement, Inc. and Leatherby Insurance Company. General Auto was, before it became bankrupt, a New Jersey corporation selling automobile insurance policies to high risk drivers. It did not issue the policies; rather, it marketed policies that were written by licensed casualty insurance companies. Leonard Lebowitz, owner of eighty-five per cent of General Auto's stock, was president of the company and controlled its operations. Leatherby Insurance Company, a California-based casualty insurance company, started to underwrite policies for General Auto in May 1969. It was replaced by Merit in 1972.

The instant dispute centers on General Auto's financial arrangements with its underwriters. A distinctive feature of these arrangements was that General Auto was paid commissions by the underwriter on a "retrospective" basis. Rather than receiving a flat percentage of the policy premiums as its commission (the ordinary practice), General Auto earned its commission on a fluctuating scale; that is, after a review of its loss experience on the policies it had sold, General Auto received a profit (if any) gauged on the difference between the premiums paid by policyholders and amounts paid on claims. The underwriter received a fixed percentage of

the premium as an "underwriting fee." Thus, General Auto functioned in large part as an insurance company without actually being one. It assumed most of the risks even though the underwriters were ultimately liable to the policyholders.

In general terms, General Auto's business was conducted as follows:

(1) General Auto agents received a commission of 15-20 percent of the premium collected by them on the policies sold.

(2) General Auto would report to the underwriter the policies it had sold and remit the premiums, less the agents' commissions.

(3) General Auto would give notice to the underwriting insurance company of any claims on the policies it had sold along with estimated settlement costs. The underwriter would place on its books the estimated settlement costs as "claim reserves," awaiting the actual amount of the claims paid.

(4) When the claims were settled, General Auto would issue drafts drawn on the underwriter to those entitled to share in the settlement.

(5) Every four months, General Auto would be paid by the underwriter a retrospective commission calculated on the basis of its earned premiums. General Auto was paid the total of earned premiums less:

(a) the fixed underwriting fees,
(b) the loss reserves, and
(c) the amounts paid on closed claims.

By virtue of this formula the lower the loss reserves were the more General Auto was paid on each quarterly settlement between General Auto and its underwriter.

In order to evaluate the financial well being of General Auto at any particular time, it was necessary to

look at the "loss ratio" of the total policies it had sold. This ratio could be calculated by comparing the combined amount of reserves and losses paid against the total amount of earned premiums. If General Auto had too high a loss ratio, the premiums would be insufficient to cover the losses on claims filed on the policies and the underwriter would be required to cover the deficiency. To protect itself against such a contingency, the underwriter required a guarantee from General Auto to cover any deficiency in premiums available to pay claims. Thus, so long as General Auto's loss ratio was low enough or was able to make up any deficiency, the underwriter had a guaranteed profit from its fixed fee.

General Auto was formed in 1969 and soon thereafter entered into a retrospective commission contract with Leatherby. The contract provided that General Auto was to be paid by Leatherby the amount of earned premiums generated by General Auto less (1) 17.5 percent as a fixed underwriter fee, (2) the amount set aside as reserves on open claims, and (3) the amounts paid out on claims. The retrospective commission was to be calculated by Leatherby on a quarterly basis. The contract gave General Auto the right to suggest the amount of loss reserves, but Leatherby retained ultimate control over setting the amount of these reserves.

By August 1970, Leatherby and General Auto were in dispute over the amount of loss reserves. Leatherby maintained that the reserves set by General Auto were forty percent less than what they should have been. General Auto thought thirty percent was more accurate. Leatherby insisted that the reserves should be increased by at least $85,000. An increase of that size would have created a severe cash flow difficulty for General Auto. President Lebowitz decided to find a replacement for Leatherby. Accordingly, he met in September 1970 with William A. F. Smith, head of the Philadelphia office of Joseph Froggatt & Co. They discussed the possibility of Froggatt providing General Auto with an audited financial statement which Lebowitz could use either to obtain public financing for purchase (or formation) of an insurance company or to induce another insurance company to supplant Leatherby.[1]

Smith said that a financial statement would aid in dealing with other insurance companies and indicated an interest in making such an audited statement. During the meeting Lebowitz told Smith about his policy of setting reserves as low as possible. Smith agreed that Froggatt would furnish the audited statement and in February 1971 telephoned Lebowitz, saying the audit for the year 1970 would start soon and that he would provide "the best looking statement he possibly could."

In March 1971 two Froggatt employees, Lotman and Cable, started the audit. During the course of their audit, they discovered a variety of disturbing situations: (1) one of the expenses claimed by General Auto in its book of accounts was "Manager's Expense." An audit of this account revealed that more than half of the $64,045 listed consisted of personal, rather than business, expenses of Lebowitz. (2) General Auto did not report or transmit all premiums due Leatherby within the time required by the agency contract. Upon questioning by Cable, Lebowitz conceded that he deliberately engaged in late reporting to enhance the cash position of General Auto. (3) Cable and Lotman discovered that General Auto was keeping two different sets of policy records. One set, for General Auto's use, was complete. The other set, for Leatherby's use, did not include the endorsements which required the payment of additional premiums.

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[1] While Lebowitz was operating G.I.A., Inc., a company authorized to write automobile casualty insurance in New Jersey and Pennsylvania, he met William A. F. Smith. On Smith's advice, G.I.A. retained Froggatt to furnish auditing services. G.I.A. became insolvent in 1968 and went out of business. Thereafter, Lebowitz formed General Auto.

After Lotman and Cable had completed their field audit, they turned over their work product to Smith.

In late June or early July 1971 Smith talked with Lebowitz several times about the drafts of the audited financial statement. The first draft submitted by Smith contained entries based on a loss ratio of approximately sixty-six percent. Lebowitz told Smith this was "totally unacceptable." Smith said he would review the matter. Several days later a new draft was produced showing a fifty-six percent loss ratio. Lebowitz said this corresponded to Leatherby's calculations which contained some "fat." A week later Smith submitted a third draft of a financial statement based on a fifty percent loss ratio. Lebowitz expressed satisfaction and said that with that kind of statement General Auto could either obtain an agency agreement with a different company or form its own company. (The trial judge excluded all testimony of conversations between Lebowitz and Smith concerning the draft statements.)

In September 1971 Lebowitz wrote a letter to Jerome Stern, president of Merit, saying that while General Auto was satisfied with its "present carrier," it had a "capacity problem" and that General Auto was "looking for an additional company so that our expansion can continue." On April 4, 1972 Lebowitz sent a copy of the Froggatt audit statement for 1970 to Stern and an in-house unaudited financial statement for the first nine months of 1972. On June 22, 1972 Merit and General Auto entered into an agency agreement similar to the Leatherby agreement, and General Auto began selling Merit policies in July 1972. In October 1972 Merit entered into a contract with Leatherby and General Auto whereby Merit assumed Leatherby's outstanding policies sold by General Auto.

In November 1972 General Auto ceased issuing policies for Merit. It did continue to adjust claims it had issued for Merit and on the assumed Leatherby policies. By the

end of July 1973 General Auto owed Merit $250,000 on promissory notes and $72,000 in premiums, and on August 8, 1973 Merit terminated its business relations with General Auto. Soon thereafter, General Auto went out of business. On the Leatherby policies assumed by Merit, Merit paid out between three and four million dollars compared to the nearly two million it had received from Leatherby. Merit also offered to make further proof of loss but was barred by an order of the trial judge.

II

The judgment of the district court must be reversed primarily because it erred in directing a verdict for the defendants. Under the rule that requires the evidence to be viewed in the light most favorable to the party opposing a motion for directed verdict, the plaintiff presented sufficient evidence to establish a *prima facie* case of fraud despite the fact that much relevant evidence was not admitted. The standard for establishing a *prima facie* case under Illinois law is that "verdicts ought to be directed . . . only in those cases in which all of the evidence, when viewed in the aspect most favorable to the opponent, so overwhelmingly favors movant that no contrary verdict based on that evidence could ever stand." *Pedrick* v. *Peoria & Eastern R.R. Co.*, 37 Ill.2d 494, 229 N.E.2d 504 (1967).

Illinois law requires that civil fraud must be established by clear and convincing evidence, *Ray* v. *Winter*, 67 Ill.2d 296, 337 N.E.2d 678 (1977), and that the essential elements of fraud are: (1) the fraudulent representation must be a statement of a material fact, as opposed to mere opinions; (2) the representation must be untrue; (3) the one making the statement must know or believe that it is untrue; (4) the person to whom the statement is made must rely on it; (5) the statement must have been made for the purpose of inducing the other party to take some affirmative action; and (6) the reliance by the person to whom the statement is made must result in his

injury. *Roth* v. *Roth*, 45 Ill.2d 19, 256 N.E.2d 838 (1970); *Roda* v. *Berko*, 401 Ill. 335, 339-40; 81 N.E.2d 912, 914 (1948). Except for the proof of the injury (damages), which was not permitted by the trial court, we are of the view that a *prima facie* case was made out by the plaintiff as to the above enumerated elements of fraud. Having already detailed the facts of this case, and since we remand for trial, no purpose would be served in further marshalling the evidence which compels that conclusion. We do note that reliance upon the report by plaintiff was primarily based on the testimony of Jerome Stern, president of Merit. Although his testimony was severely restricted (erroneously we think), that which was admitted made reliance a jury question.

Stern testified that it was General Auto's certified audit report which induced him to follow through on the business arrangement with General Auto. He said that he was particularly impressed with defendants' "clear opinion" showing that General Auto had a substantial net worth and high operating income. Stern further testified that he knew Froggatt to be a well-known accounting firm in the insurance field and believed at the time that it had given "an unqualified opinion that those statements fairly presented" General Auto's financial position. Thus, it became a jury question as to whether Stern was justified in relying on the audit report which, in part at least, indicated General Auto's financial health in 1972.

Defendants argue that plaintiff failed to establish a *prima facie* case that they knowingly made material misrepresentations for the fraudulent purpose of inducing Merit to act. Although much relevant and material evidence going to fraudulent intent was excluded erroneously by the trial judge, even that which was admitted was sufficient to present a jury question. Smith knew why the audit was made and he knew that a limited class of persons might rely on it. Moreover, Lebowitz testified about a meeting he had with Smith in September 1970:

> "I discussed at that time the problems that I was having with Leatherby Insurance Company in regard to the increases of loss reserves and I explained to him [Smith] the purpose of the audit was so that I would have a certified statement in order to attempt to obtain an underwriter for a public issue at the time and also that I was to approach other companies in an attempt to obtain another contract. He advised me at that time that he would look around and see what companies he could possibly suggest and he also felt that it was good to have a certified statement at that time."

III

Contrary to the dissent, the majority of the panel is of the view that the trial court erred in dismissing Count One of the amended complaint alleging negligence in defendants' conduct in preparing and submitting the 1970 General Auto audit. Under Illinois law, privity between Merit and the defendants is not required. *Rozny* v. *Marnul*, 43 Ill.2d 54, 250 N.E.2d 656 (1969). That case is the controlling authority in this area of the law of Illinois. One of the relevant criteria listed in *Rozny* is that potential liability for a negligent audit must be directed to a comparatively small group only one of whom would suffer a loss. The trial judge's ruling was based on this criterion. Defendants support the ruling by arguing that the extension of liability for negligence to unforeseen third parties "would impermissively extend the number of potential plaintiffs to an undeterminable class." App. Brief at 117. Plaintiff counter-argues that the class of insurance companies able to do business with General Auto, of which Merit was a member, was considerably more limited than the class of persons who might have bought the house in *Rozny*. To choose between these two contentions at the pleading stage is impermissible. The issue must be resolved at trial. One of the paragraphs of Count I reads:

> Foggatt knew or should have known that its certified financial statements would be used by third persons such as plaintiff as a basis for business decisions involving General Auto Replacement, Inc.

This count, liberally interpreted, alleges a class of insurance companies which, like Merit, could provide the kind of insurance policies General Auto sold. Thus, the complaint was sufficient to withstand defendants' challenge that the complaint was defective for want of facts showing that they knew of a limited class that might rely on the audit report. In all other respects the complaint met the requirements of Fed. R. Civ. P. 8(a). *Conley* v. *Gibson,* 355 U.S. 41, 47-48 (1957); *see e.g., Eyerly Aircraft* v. *Killian,* 414 F.2d 591, 603 5th Cir. (1969). Illinois procedure requires a plaintiff allege freedom from contributory negligence. The complaint contains no such allegations. But the allegation was unnecessary because under Fed. R. Civ. P. 8(c) contributory negligence is an affirmative defense which a defendant, not a plaintiff, must plead.

With respect to Count Two, Illinois does not recognize gross negligence as an independent ground for recovery. *C.R.I. & P. Ry.* v. *Hamler,* 215 Ill. 525 (1903). Accordingly, the trial court did not err in dismissing Count Two.

Plaintiff contends that the trial judge erred in refusing to require Anthony Colao, one of the defendants, to complete his deposition and that such refusal, under the circumstances, was a manifest abuse of discretion. We need not recite those circumstances because we believe the problem should, if the occasion demands, be reviewed and ruled upon anew by the district court at the new trial.

Because we remand for a new trial, we deem it unnecessary to comment on the numerous allegedly erroneous evidentiary rulings by the trial judge (other than those to which we have alluded in general terms in Part II).

The judgment of the district court is reversed and vacated. The cause is remanded for a new trial under the provision of Circuit Rule 18.

Wood, *Circuit Judge,* dissenting in part. The majority view of this case was my initial view since it appeared that jury questions had been appropriated by the trial court.[1] That remains a reasonable view, but after considering the case further I have come to the conclusion that plaintiff failed to establish a *prima facie* case as to Count III. In reaching that conclusion, I have given consideration not only to the evidence which was admitted, but also to that which was excluded.

Neither party challenges the applicability of Illinois law. The leading Illinois case determining the standard for the direction of verdicts as well as entry of judgments n.o.v. is *Pedrick* v. *Peoria & Eastern R.R. Co.,* 37 Ill. 2d 494, 229 N.E.2d 504 (1967), in which Mr. Justice Underwood in an exhaustive opinion resolved the issue. The case remains a current statement of Illinois law. *See Bailey* v. *City of Decatur,* 49 Ill. App. 3d 751, 364 N.E.2d 613 (4th Dist. 1977). The stated rule, as the majority notes, is that "verdicts ought to be directed and judgments n.o.v. entered only in those cases in which all of the evidence, when viewed in the aspect most favorable to the opponent, so overwhelmingly favors movant that no contrary verdict based on that evidence could ever stand." *Pedrick,* 37 Ill. 2d at 510, 229 N.E.2d at 513-14. However, as a prelude to stating the rule, the Illinois Supreme Court commented:

> Clearly, the constitution does, and judges should carefully preserve the right of the parties to have a substantial factual dispute resolved by the jury, for it is here that assessment of the credibility of witnesses may well prove decisive. (See Ill. Const. art.

[1] Much of the delay in the resolution of this case on appeal results from the change of my initial view.

> II, sec. 5; Note, 107 U. Pa. L. Rev. 217.) But the presence of *some* evidence of fact which, when viewed alone may seem substantial, does not always, when viewed in the context of all of the evidence, retain such significance. As the light from a lighted candle in a dark room seems substantial but disappears when the lights are turned on, so may weak evidence fade when the proof is viewed as a whole. Constitutional guaranties are not impaired by direction of a verdict despite the presence of some slight evidence to the contrary (*Chamberlain*; Blume, "Origin and Development of the Directed Verdict," 48 Mich. L. Rev. 555, 576-7), for the right to a jury trial includes the right to a jury verdict only if there are factual disputes of some substance.

37 Ill. 2d at 504-05, 229 N.E.2d at 510. It must also be borne in mind that allegations of fraud, as distinguished from the ordinary civil case, must be established by clear and convincing evidence. *Roy* v. *Winter,* 67 Ill. 2d 296, 367 N.E.2d 678 (1977); *Mock* v. *Earle M. Jorgensen Co.,* 467 F.2d 1177 (7th Cir. 1972); *Classic Bowl, Inc.* v. *AMF Pinspotters, Inc.,* 403 F.2d 463 (7th Cir. 1968); *Hubert* v. *May,* 292 F.2d 239 (7th Cir. 1961). In applying the Illinois rules, viewing the evidence most favorably to plaintiff, we are to decide only whether the plaintiff had made out a *prima facie* case so as to justify permitting a properly instructed jury to make the ultimate factual determinations.

Plaintiff's obviously heavy burden was to affirmatively establish against these particular defendants a *prima facie* case as to each and every one of the required fraud elements. No aspect of the fraud allegations could be presumed. *Classic Bowl, Inc.* v. *AMF Pinspotters, Inc.,* 403 F.2d 751 (7th Cir. 1966). No evidence was received on damages, as that issue had been reserved by the trial court. In the business relationships between all these parties, it is evident that there was fraud, fraud against

plaintiff by Lebowitz, president of General, and by Lebowitz and Leatherby together against plaintiff. The present case against these defendants is only one aspect of the litigation generated elsewhere by these activities.

One of my concerns with this case was the extraordinary success of defendants in excluding plaintiff's evidence. Almost all of defendants' objections were allowed. In objecting to the admission of plaintiff's documentary evidence, defendants were even more successful as all or almost all their objections were sustained. The result was that plaintiff was required to make numerous offers of proof, possibly well over a hundred. I do not view it as necessary to delve individually into the mass of evidentiary rulings. Some of those evidentiary rulings I consider to have been in error, but I have approached this case on the broader basis by assuming that the more important excluded evidence had been admitted. At best the evidence tells the story of careless auditing by defendants and the devious intentions of Lebowitz and Leatherby. However, viewing all the evidence most favorably to plaintiff, a *prima facie* case of fraud against these defendants, even with a liberal use of inferences, was not established. Nothing short of pure speculation could save the plaintiff's case, and neither a jury nor ourselves may indulge in that.

Let us look further at the individual defendants. Colao was a partner and as head of Froggatt's New York office signed the audit on behalf of the firm. Had his deposition been admitted, which I will consider later, it would, as far as it was completed, show nothing more than negligence in his review of the finished audit. Johnson, Ginsburg and Miller were named merely in their capacities as partners of the firm, although Miller who had been an employee became a partner only after the audit was completed. Cable and Sexton were also employees. Sexton had spent a few hours assembling documents in connection with the audit. Cable, a senior accountant, and another accountant not presently involved, did the audit field work.

What they came across in their audit was reported to their superiors, usually Smith. Smith, however, is of more interest and significance.

Smith, not a C.P.A., was head of Froggatt's Philadelphia office. He had previously done work for a prior company controlled by Lebowitz in which some financial problems had also developed. They became personal friends and maintained their business and personal relationship after General was formed. When problems also developed in General, Smith suggested that Lebowitz form his own insurance company as a substitute for Leatherby. Lebowitz offered Smith the position of treasurer, along with stock in any newly organized insurance company, provided the financial statements to be prepared reflected a favorable picture and the public stock offering was successful. Smith was interested. Lebowitz also mentioned the possibility of finding an existing insurance company as a substitute for Leatherby. Subsequently Smith assured Lebowitz that he would provide the best financial statement possible. In the first draft submitted to Lebowitz, some entries were based on a loss ratio which Lebowitz found unacceptable. This was favorably revised by Smith by applying what he termed "the rule of reason." After this 1970 audit was completed, Lebowitz, abandoning his own insurance company idea, decided to try to interest some other insurance company to replace Leatherby. He discussed a prospect list of about 250 insurance companies with Smith. Financial problems continued to develop in General, which also came to Smith's attention. General arranged for another firm to do the audit for 1971, but that audit was not completed.

It is arguable whether any untrue material fact was actually stated in the audit, but I view that as a jury issue. It is also arguable that if it contained an untrue material fact that it was known to be untrue, but I view that also as a jury issue. It is, however, considerably less arguable that plaintiff had any right to rely upon the audit and did in fact rely upon it.

Stern, the president of plaintiff, claims he relied on the audit as a basis for his entering a contract with General. There is no substantial evidence to that effect, only Stern's self-serving conclusion. According to him, he relied on the 1970 audit in June 1972 when contracting with Lebowitz and again on October of 1972 when contracting with Leatherby and Lebowitz. The financial information prepared by Froggatt was already 16 months old when Stern first received it. There was no privity between Stern and Froggatt. The audit had not been proposed specifically for Stern's use, but for a possible public stock offering or for use with numerous companies. That possible use does not constitute use only by a limited class of persons. During this time it also came to Stern's attention that Lebowitz had been indicted by federal authorities in New York. Stern also became aware that there was pending litigation between General and Leatherby. Stern did some independent checking but it was surprisingly limited, shallow and deficient. Stern was a lawyer and a CPA with insurance experience. Considering the evidence admitted and offered, Stern's own poor business judgment should not be converted into a *prima facie* case of fraud by these accountants.

The Illinois law as to reliance is stated in *Schmidt* v. *Landfield,* 20 Ill. 2d 89, 94, 169 N.E.2d 229, 231-32 (1960):

> As a general rule one who is guilty of fraudulent misrepresentation cannot interpose a defense that the person defrauded was negligent in failing to discover the truth. The general rule is subject to the qualification, however, that the party seeking relief had a right to rely upon the representation made. This court has pointed out accordingly that "In all cases where it is sought to hold one liable for false representations, the question necessarily arises. whether, under all circumstances, the plaintiff had a right to rely upon them. In determining this question, the representations must be viewed in the light

> of all the facts of which the plaintiff had actual notice, and also of such as he might have availed himself by the exercise of ordinary prudence." The rule is well established that a party is not justified in relying on representations made when he has ample opportunity to ascertain the truth of the representations before he acts. When he is afforded the opportunity of knowing the truth of the representations he is chargeable with knowledge; and if he does not avail himself of the means of knowledge open to him he cannot be heard to say he was deceived by misrepresentations. (Citations omitted.)

Stern was chargeable with knowledge.

The final fraud issue requires proof that the false material fact was made for the purpose of inducing the other party to act. Plaintiff clearly failed to establish a *prima facie* case on this aspect also. Smith knew that Lebowitz wanted to start his own insurance company by a public stock offering or to seek a replacement insurance company for Leatherby. There is, however, no substantial evidence which would expand Smith's general knowledge of Lebowitz' possible general purposes into a *prima facie* finding that the audit was for the purpose of "inducing" plaintiff to act at a much later date. Smith's activities evidence nothing more than a possible conflict of interest arising out of the job offer possibility, careless supervision of the audit, and a close relationship with Lebowitz, his client, whom he made some effort to please. It doesn't add up to a *primia facie* case of fraud.

Plaintiff had four months of trial in which to try to establish a *prima facie* case of fraud. Perhaps some judges would have played it safe and permitted the jury an opportunity to consider the case. If the jury, however, had brought in a fraud verdict for plaintiff, it could not have been permitted to stand. The evidence of fraud was considerably less than clear and convincing.

Plaintiff objects that it was not permitted by the trial court to use the incomplete deposition of defendant Colao, a partner of Froggatt in New York, who signed the audit for the firm with little knowledge about its preparation. There was no need for the majority to consider this issue. The deposition began on June 27, 1977, and resumed on September 13, 1977. On September 23, 1977, plaintiff gave notice of the continuation of the deposition for October 4, 1977. On that date Colao was out of the country. In any event there were five other depositions previously scheduled for that date. Trial had been set for October 11, 1977. Between September 23 and October 31, 1977, there were more than 60 depositions already scheduled. On October 11, the trial was rescheduled to October 18. Also on October 11, 1977, plaintiff served notice to continue the deposition on October 14, 1977. On October 14, 1977, there were already three other depositions previously scheduled in New York and Chicago. Subsequently, in the ninth week of trial, plaintiff attempted to use the incomplete Colao deposition. The deposition had not been filed in accordance with Rule 30(f) of the Federal Rules of Civil Procedure or with local Rule 18. The trial court also noted that plaintiff had had over two years in which to complete discovery. I find no error in the court's ruling under these particular circumstances. Plaintiff argues that the Colao testimony was "crucial," but gives us little insight as to how it was crucial. At most it was only evidence of Colao's negligence.

There remains the issue of pretrial dismissal of Counts I and II which alleged negligence and gross negligence. Defendants argue that defendants as accountants cannot be liable to plaintiff for negligence unless in privity with plaintiff or unless defendants could foresee that plaintiff would rely on the audit. There was, defendants argue, no duty of reasonable care owing plaintiff by defendants. Further defendants argue that plaintiff did not disclaim its own lack of contributory negligence.

Looking to Illinois law, both parties find support in *Rozny* v. *Marnul,* 43 Ill. 2d 54, 250 N.E. 2d 656 (1969). In that case a land surveyor hired by a prior owner of the real estate was held liable to a third party purchaser of the real estate who acted in reliance on the survey. It was held in the circumstances of that case that privity of contract was not applicable and did not bar recovery. The court in coming to that conclusion pays particular attention to the opinion of Mr. Justice Cardozo in *Ultramares Corp.* v. *Touche, Niven & Co.,* 255 N.Y. 170, 174 N.E. 441 (1931), considered to be a leading case on the issue of accountant's liability. It was held in *Ultramares* that no cause of action would lie for negligence to third parties who had loaned money to an insolvent firm in reliance on the defendant's audit. Mr. Justice Cardozo wrote:

> If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate class. The hazards of a business conducted in these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.

225 N.Y. at 179, 174 N.E. at 444.

In *Rozny* the Illinois Supreme Court commented, "We agree that the unknown and unlimited liability factor, as so ably stated by Mr. Justice Cardozo in the *Ultramares* case, is not to be lightly discounted. But we deal here with a defendant who has included in his inaccurate plat an 'absolute guarantee for accuracy.'" 43 Ill. 2d at 66, 250 N.E.2d at 662. The court then carved out an exception specifically setting forth these factors as controlling:

> (1) The express, unrestricted and wholly voluntary "absolute guarantee for accuracy" appearing on the face of the inaccurate plat;

> (2) Defendant's knowledge that this plat would be used and relied on by others than the person ordering it, including plaintiffs;
>
> (3) The fact that potential liability in this case is restricted to a comparatively small group, and that, ordinarily, only one member of that group will suffer loss;
>
> (4) The absence of proof that copies of the corrected plat were delivered to anyone;
>
> (5) The undesirability of requiring an innocent reliant party to carry the burden of a surveyor's professional mistakes;
>
> (6) That recovery here by a reliant user whose ultimate use was foreseeable will promote cautionary techniques among surveyors.

43 Ill. 2d at 67-68, 250 N.E.2d at 663.

In Count I, plaintiff alleges that "Froggatt knew or should have known that this certified audit would be viewed and relied upon by third parties including plaintiff." I do not believe that the allegation brings plaintiff within the *Rozny* exception requiring a showing of liability to a comparatively small group. Had plaintiff amended these allegations to conform to its own proof, the group would be seen not to be small. It would have included, as we have already noted, the general public as Lebowitz was considering forming a new insurance company with a public stock offering. It would also have included several hundred insurance companies as prospects to substitute for Leatherby. The Illinois Supreme Court also took particular note of the survey's written guarantee of absolute accuracy, which is not claimed in the present case. Nor is there any allegation a corrected audit was prepared, but not distributed. We find no indication in the Illinois law that persuades us that Illinois is ready to broaden the liability of accountants to encompass the situation in this case.

It is recognized in Illinois that the plaintiff has the burden of proof in showing the absence of contributory negligence. However, Rule 8(c) of the Federal Rules of Civil Procedure is considered to be applicable and includes contributory negligence as an affirmative defense. That being so, plaintiff need not allege due care, but lack of contributory negligence nevertheless remains a matter of plaintiff's proof. Though the plaintiff did not have to allege freedom from contributory negligence, plaintiff would still have had to explain away its reliance upon an outdated audit. The plaintiff, therefore, is in no position to complain about the negligence of defendants that there may be seen in the evidence. It is somewhat of an anomaly that what the defendant must allege, the plaintiff must prove. On this issue I would adopt the reasoning of Judge Foreman in *Gilmore* v. *Witschorek,* 411 F. Supp. 491 (E.D. Ill. 1976), and his consideration of the authorities cited therein.

As to Count II, the gross negligence count, we are given no support for plaintiff's view that gross negligence exists in similar cases as a separate cause of action in Illinois. It is generally considered that Illinois does not recognize degrees of negligence as distinguished from wilful and wanton conduct. As to Count II, I do not dissent, but I respectfully dissent from the majority view on Counts I and III.

A true Copy:

Teste:

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Clerk of the United States Court of Appeals for the Seventh Circuit

IN THE UNITED STATES DISTRICT COURT
Northern District Of Illinois
Eastern Division

No. 75 C 899

MERIT INSURANCE COMPANY,

Plaintiff,

v.

ANTHONY COLAO, et al.,

Defendants.

Before the Honorable JULIUS J. HOFFMAN, Judge, and a Jury.

Wednesday, March 1, 1978,
2:00 o'clock p.m.

(Court was resumed pursuant to adjournment.)

PRESENT:

MR. HOLSTEIN,
MR. SIMON,
MR. STEIN.
MR. LEDERLEITNER,
MR. ROWE,
MR. WEITHERS,
MR. GILLIGAN.

The Clerk: 75 C 899, Merit Insurance Company v. Colao, et al., for trial.

(Whereupon, the following further proceedings were had in open court, out of the presence and hearing of the jury, to-wit:)

The Court: Gentlemen, after about 17 weeks of trial the plaintiff Merit Insurance Company has now completed the presentation of its case in chief and has rested. At the close of the plaintiff's case on motion of his attorney, the defendant Allen Lotman was dismissed on the order of the Court from this suit as a party-defendant.

The Court granted this motion to dismiss when plaintiff's counsel indicated that because of an agreement worked out between the plaintiff and the defendant Lotman, the plaintiff had no objection to the entry of an order of dismissal. The remaining defendants have all and each of them now filed motions for a directed verdict.

It is their position, as presented in the arguments of their lawyers, that the plaintiff has failed to establish a prima facie case, both as to the matter of liability and damages, so that the defendants are entitled to judgments in their favor as a matter of law.

The Court has heard arguments from both the lawyers for the plaintiff and the defendants and the matter is now before the Court this afternoon for rulings on those motions. Motions for a directed verdict are provided for by Rule 50(a) of the Federal Rules of Civil Procedure. On ruling on such a motion, the Court must evaluate the evidence presented and determine whether it justifies submission of the case to the jury. Woods v. Geifman Good Stores Incorporated, 311 F.2d 711, Seventh Circuit, 1963, Lambie v. Tibbits, 267 F.2d 902, Seventh Circuit, 1959.

The test generally applied in Federal Courts is whether there can be but one conclusion as to the verdict reasonable men could reach. Simblest v. Maynard, 427 F.2d 1 at Page 4, Second Circuit, 1970, Riggs v. Penn Central Railroad Company, 442 F.2d 105, Seventh Circuit, 1971, and Farmers State Bank of Valparaiso v. Darvo Corporation, 321 F.2d 38, Seventh Circuit, 1963.

While the Federal Courts are under a duty to view the evidence in the light most favorable to the party opposing the motion, a mere scintilla of evidence is not adequate to require the submission of a case to the jury. Rather, the trial judge is under a duty to direct a verdict in all cases where he concludes that the evidence will not support any other verdict. Hohmann v. Packard Instrument Company, 471 F.2d 815 at Page 819, Seventh Circuit, 1973, citing the statements of the United States Supreme Court in Gunning v. Cooley, 281 U.S. 90, 1938.

Because this case has been tried by the Court pursuant to its diversity jurisdiction, the controlling substantive law must be state law. Erie Railroad Company v. Tompkins, 304 U.S. 64, 1938.

In this case, no party has made any assertion that the law of any state other than Illinois should apply. In fact, by their use of Illinois law in various legal arguments made both during the pretrial and trial stages of this litigation, all parties must be considered to have conceded that it is Illinois law which governs the substantive issues in this case. This Court accepts that determination.

In its arguments in opposition to these motions for directed verdicts, the plaintiff has argued that because the Court's jurisdiction is based on diversity of citizenship, the Illinois and not the Federal standard on the direction of a verdict is controlling.

There is disagreement among the circuits on this point Boing v. Shipman, 411 F.2d 365 at Page 368, Note 2, Fifth Circuit (1969).

While the issue is an unsettled one in the opinion of this Court, the applicable state standard as to the direction of a verdict controls in diversity cases. Illinois State Trust Company v. Terminal Railroad Association of St. Louis, 440 F.2d 497, Seventh Circuit (1971); Wieloch v. Rogers Cartage Company, 290 F.2d 235 at Pages 237, 238, Seventh Circuit (1961).

As stated by the Illinois Supreme Court in the case of Pedrick v. Peoria and Eastern Railroad Company, 37 Ill. 2d 494 at Page 510, 229 N.E.2d 504 at Pages 513, 514 (1967) and adopted by the Court in the Illinois State Trust Company case previously referred to by the Court, the Illinois rule is that 'Verdicts ought to be directed only in those cases in which all of the evidence, when

viewed in its aspect most favorable to the opponent so overwhelmingly favors the moving party that no contrary verdict based on that evidence could ever stand."

Under the authority of the Illinois State Trust Company case and Wieloch v. Rogers Cartage Company, to which the Court has previously alluded, this Court has applied the assertedly stricter Illinois standard in deciding these motions.

The issues tried in this case are those framed by the third amended complaint and the answers thereto. The plaintiff's pleading as originally filed was in ten counts, however, Counts I, II, and IV through X have previously been dismissed. The plaintiff, therefore, has proceeded only under Count III.

The defendants named in that count were Anthony Colao, Roy V. Johnson, Morris I. Ginsburg, Paul J. Miller, William A. F. Smith, George R. Cable, Harold J. Sexton and Allen Lotman. As I pointed out a moment ago the defendant Lotman has been dismissed as a defendant in this case.

These defendants were named as defendants, both individually and doing business as Joseph Froggatt & Company.

The plaintiff in its pleading alleges that these defendants acting in their capacity as employees of the then national acounting firm of Joseph Froggatt & Company performed an audit of the individual and combined financial statements of General Auto Placement, Inc., Loss Adjustment Corporation, and General Auto Club Foundation for the year ending December 31, 1970.

It is the plaintiff's position that the audit was fraudulently conducted and it is on this theory that the plaintiff has proceeded to trial before the Court and jury.

More specifically, in Count III of the third amended complaint the plaintiff alleges in substance as follows:

"The defendant Joseph Froggatt & Company was at all times relevant to this action an accounting firm, which operated as a partnership in numerous parts of the country, that the individual defendants were partners and/or employees of the Froggatt firm, and that that firm was subsequently absorbed into the accounting firm of Coopers & Lybrand."

The plaintiff's pleading goes on to allege that acting in the capacity as a public accounting firm, Froggatt performed a certified audit of the individual and combined financial statements of General Auto Placement, Inc., Loss Adjustment Corporation, and The General Auto Club Foundation for the period ended December 31, 1970, that all three of these affiliated companies were New Jersey corporations, and that at the completion of that audit on July 15, 1971, Froggatt issued its audit report, which report is now Plaintiff's Exhibit No. 29 in evidence.

Included in that report were individual and combined balance sheets of the given company as of December 31, 1970, and individual and combined income statements for the year then ended. Also included in that report was what is commonly referred to in the accounting profession as the auditor's opinion. The opinion issued by Froggatt stated as follows:

> 'We have examined the individual and combined balance sheets of General Auto Placement, Incorporated, Loss Adjustment Corportion, Incorporated, and General Auto Club at December 31, 1970, and the related statements of income for the year then ended. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. In our opinion, the financial statements referred to above present fairly the financial position of the companies at December 31, 1970, and the results of operations for the periods

then ended, both individually and combined, in conformity with generally accepted accounting principles applied on a basis consistent with the preceding period."

It is on this opinion that Count III of the plaintiff's third amended complaint is based. According to the allegations in the pleading, "Froggatt knew or should have known that this certified audit would be viewed and relied upon by third parties including the plaintiff."

Pleading further, the plaintiff states that it did rely on the audit opinion and the information contained in the certified financial statements when on June 22, 1972, a "retrospective agreement" was entered into between the plaintiff Merit Insurance Company and General Auto Placement, Incorporated. Both Merit Insurance Company and General Auto Placement, Incorporated have at all relevant times operated in the casualty insurance business. Merit is a casualty insurer which is licensed to underwrite insurance in a number of states. During the period of its existence, General Auto Placement, Incorporated was an insurance agency operating in the state of New Jersey.

Under the terms of the parties' "retrospective agreement," the plaintiff was to act as the underwriter for policies written by General Auto Placement. However, instead of General Auto Placement realizing a commission based simply on the volume of policy premiums generated, its profit was based on actual loss experience. In other words, under the parties' agreement, which is now Plaintiff's Exhibit 105 in evidence, General Auto Placement was to sell Merit Insurance Company policies and receive as its compensation a payment which was calculated by subtracting from premiums paid all insurance claims, expenses of managing the policies and a fixed underwriting fee.

Prior to June 22, 1972, General Auto Placement had a retrospective agreement of a similar kind with Leather-

by Insurance Company. It is the position of the plaintiff Merit Insurance Company that in further reliance on Froggatt's audit report in October of 1972, it entered into an agreement with Leatherby whereby Merit "took over" General Auto Placement's previously written insurance business which business was then being carried by Leatherby. The agreement further provided that the plaintiff was to assume liability for all unpaid claims resulting from accidents occurring prior to July 1, 1972. In return, Leatherby made a cash payment to the plaintiff of approximately $1,900,000. That payment was made in two installments, one in October and the other in December of 1972. This agreement is now Plaintiff's Exhibit 232 in evidence.

In November of 1972, subsequent to the consummation of the assumption agreement between the plaintiff and Leatherby Insurance Company, General Auto Placement was suspended from writing any further insurance policies in the state of New Jersey. In effect, General Auto Placement was put out of business. Acting pursuant to its agreement with General Auto Placement and the Leatherby Insurance Company, plaintiff has since that time managed the insurance policies of General Auto Placement.

Plaintiff's allegations against the defendants in this case are as follows:

The plaintiff asserts that the financial statements of General Auto Placement, Incorporated for the year ended December 31, 1970, materially misstated the financial position of General Auto Placement as of that date and materially misstated the results of its operations for that year. Those statements are alleged to have failed to reflect unreported claims, prematurely closed claim files and unreserved claim files. They are also assertedly erroneous because various items listed as expenses in the income statement were incorrect. The plaintiff's pleading goes on to allege that the defendants are liable to

the plaintiff because "Froggatt fraudulently conducted its audit and fraudulently certified the financial statements of General Auto Placement, Incorporated.

"More specifically, it is averred that the defendants failed to properly audit claim files of pending claims, failed to apply auditing procedures appropriate under the circumstances and failed to note insufficient claim experience in its examination of the financial statements of General Auto Placement, Incorporated."

These defendants are alleged to have had a duty to audit and certify the books and records of General Auto Placement, Incorporated with the due care commonly exercised by members of the accounting profession. In stead of complying with this duty, so it is alleged, the defendants "fraudulently performed" the General Auto Placement audit.

The plaintiff asserts that as a direct result of its reasonable reliance on the fraudulent audit report issued by the defendants, it has suffered money damages, loss of business opportunities and "embarrassment within the insurance industry and with various state Departments of Insurance of the states wherein it does business."

Under Illinois law in order to establish a prima facie case of fraudulent misrepresentation, the plaintiff must present evidence to establish each of the following: one, that the defendants made a false representation of a material fact; two, that the defendants knew or believed it to be untrue; three, that there was an intention to deceive the plaintiff; four, that the plaintiff did place reliance on the misrepresentations, which reliance was reasonable; and, five, that as a result of plaintiff's justifiable reliance, it has sustained injury. Roth v. Roth, 45 Illinois 2d 19, 256 N.E. 2d 838 (1970); Zeilenga v. Stelle Industries, Incorporated, 52 Ill. Appellate 3d 753, 367 N.E. 2d 1347 (1977); Davis v. Nehf, 14 Ill. Appellate 3d 318, 302 N.E. 2d 382 (1973).

The plaintiff has taken the position that under the Illinois law it need establish each of these elements only by a preponderance of the evidence. In support of this argument, the plaintiff relies primarily on the case of Harry Alter Company v. Chrysler Corporation, 285 F.2d 903, Seventh Circuit (1961).

The Court has examined this and the other cases cited by the plaintiff, as well as other authorities available on this point. From its reading of these citations, the Court is satisfied that in Illinois the burden of proof in fraud cases is not the preponderance standard as argued by the plaintiff, rather under the controlling Illinois law, in order to establish a prima facie of fraud, a plaintiff must establish each of the elements of fraud by evidence that is both clear and convincing. Lagen v. Lagen, 14 Ill. App. 3d 74, 302 N.E. 2d 201 (1973); Atlee Electric Company, Incorporated v. Johnson Construction Company, 14 Ill. App. 3d 716, 303 N.E. 2d 192 (1973); Classic Bowl, Incorporated v. AMF Pinspotters, Incorporated, 403 F.2d 463, Seventh Circuit (1968).

The trial transcript in this case now contains in excess of 11,000 pages. The plaintiff has presented testimony from about 19 witnesses, some of which were physically present in court. However, in a number of instances only deposition testimony from the various individuals was introduced or offered.

Viewing all of this evidence in the light most favorable to the plaintiff as this Court is required to do in ruling on these motions for directed verdicts, the Court concludes that the evidence can only support verdicts in favor of each defendant and against the plaintiff.

After giving due consideration to both the evidence and the arguments of plaintiff's counsel, the Court finds that the record does not contain evidence to support the conclusion that any of the defendants has committed the fraud alleged in the third amended complaint.

For this reason, this Court is obligated to grant and does grant the instant motions by the defendants, Illinois State Trust Company v. Terminal Railroad Association of St. Louis, to which this Court has previously alluded.

Accordingly, the Court will call in the jury and make appropriate instructions to the jury.

Mr. Marshal, will you please bring in all of the jurors and the alternates?

Give me the names of the alternates, please.

(Whereupon, the following further proceedings were had in open court, in the presence and hearing of the jury, to-wit:)

The Court: Good afternoon, ladies and gentlemen of the jury. You may take your chairs.

The first announcement I wish to make to the jury is that the defendant Allen Lotman has been dismissed on the order of the Court from this case on the motion of Mr. Lotman's attorney and that motion was not opposed by the lawyers for the plaintiff.

I next want to address especially the alternate jurors. I might say the Court is about to direct the members of the jury to bring in a certain verdict, and since that is a matter as between the Court and the regular members of the jury, it becomes my duty to excuse all of the alternate jurors. Therefore, Mrs. Prill, Mr. Hemmingsen, and Mrs. Bialobok, I hope I pronounced all of your names correctly, you have the thanks of all of us, the parties and the Court, everyone interested in this case, for your services during the many, many weeks of this trial.

I do not know whether you kept track of it or not, but we have been here about 17 weeks, I think. We are very grateful to you. As you know, we choose alternate jurors so we will be ready to proceed with the case

if we have an accident—if any juror suffers an accident. I am very glad to note here on our record that one of our ladies here did suffer an accident. She, fortunately, has recovered. I see her sitting comfortably in the jury box.

The alternates I have mentioned are excused now, again I say with the appreciation of all of us for your service. You may be excused from the regular service here.

(Alternate jurors excused)

The Court: Ladies and gentlemen of the jury, I don't remember if we were ever told what your experience as jurors was or has been, but in the trial of a jury case, whether it is a civil case or a criminal case, the jurors are what we say in the law the judges of the facts. The Court has the exclusive responsibility of making a determination of what the applicable law of the case is. If the Court would determine after hearing arguments fully that the plaintiff in a given case has not made out a case which entitles it to the relief sought or any part of the relief sought in the plaintiff's pleading, in the case the pleading was the third amended complaint, it becomes the duty of the Court to instruct the jury appropriately in accordance with that determination. Accordingly, ladies and gentlemen of the jury, I order you to sign this form of verdict when you retire to the jury room. This document is entitled "Verdict" with the title of the case above it and it reads this way:

> "We the jury find in favor of the defendants Anthony Colao, Roy V. Johnson, Morris I. Ginsburg, Paul J. Miller, William A. F. Smith, George R. Cable and Harold J. Sexton and against the plaintiff Merit Insurance Company."

Now, I omitted to say that before you sign this verdict, you proceed in the jury room to elect from your

members what we must necessarily call a foreperson rather than a foreman or forewoman. Foreperson will be the accurate the proper characterization.

There are six lines for your signatures, and when you have completed the signing of this verdict, you will let the marshal know. He will be waiting outside the door. He will bring the verdict to the clerk of the court who will read the verdict and then the Court will enter an appropriate judgment on the verdict.

Mr. Marshal, will you please take the members of the jury to the jury room and proceed as indicated by the Court.

(Whereupon, the jury retired to the jury room.)

The Court: I take it the gentleman who has the document in his hand is the foreman of the jury. Have all of the jurors executed the verdict?

Juror Anchor: Yes, they have.

The Court: Will you hand it to the marshal and, Mr. Marshal, will you please give it to the clerk and I direct the clerk to read the verdict.

The Clerk: (Reading:)

> "We the jury find in favor of the defendants Anthony Colao, Roy V. Johnson, Morris I. Ginsburg, Paul J. Miller, William A. F. Smith, George R. Cable, Harold J. Sexton, and against the plaintiff Merit Insurance Company."

The Court: You may sit down, ladies and gentlemen of the jury.

There will be, Mr. Clerk, a final judgment entered on the verdict brought in and after execution of it by the jury. The Court orders that the defendants and each of them may go hence as we say in the law without day. Further, the Court orders that each defendant have and

recover his court costs and charges on his behalf expended and have execution thereof.

If there is any further business before the Court, I will be glad to hear from counsel.

There being no further business before the Court, Mr. Marshal—oh, I might say, ladies and gentlemen of the jury, I had forgotten. I thought when I thanked the alternates that I had also thanked you, but I recall I did not.

This has been a extraordinary case in that the average case here does not occupy as long a time as 17 weeks as this one did.

We are especially grateful to all of you for the use of your time and effort and intelligence in listening to this case. Sometimes when a juror serves a long time and is obligated to sign a verdict, which the Court directs, direct is a word we use in the courts, he might be unhappy about it. But the answer to that is that if the trial judge believes that a plaintiff has not met the requirements of the law as far as the evidence is concerned, it is his duty and obligation under the law to so direct the jury.

And I thank you now again each and every one of you, and I think the marshal will give you your instructions. I think you may be discharged; is that right?

The Marshal: That is right.

The Court: Thank you very much.

Mr. Holstein: Your Honor, before the jury leaves, on behalf of Merit Insurance Company, I would like to thank each and every one of the jurors for taking time off from their busy life to come in and listen most attentively to everything that has gone on. Thank you very much.

Mr. Weithers: With the Court's permission, I would like to associate counsel for the defendants with plaintiff's remarks.

The Court: I am sure you all do appreciate the efforts of the jurors.

You are excused from further service here and I hope the juror who suffered an injury has complete recovery.

Juror Hunter: Thank you.

(Jury excused.)

The Court: Mr. Marshal, the Court will be in recess until tomorrow morning at 10:00.

(Which were all the proceedings had in the trial of the above-entitled cause on the days and dates aforesaid.)

In The

UNITED STATES DISTRICT COURT

Northern District of Illinois

Eastern Division

MERIT INSURANCE COMPANY,

Plaintiff,

v.

ANTHONY COLAO, et al.,

Defendants.

No. 75 C 899

CERTIFICATE

I Hereby Certify that the proceedings had in the above-entitled cause before the Honorable Julius J. Hoffman, one of the Judges of said court, and a jury, in his courtroom in the United States Courthouse, Chicago, Illinois, were reported by me and under my direct personal supervision, commencing on Tuesday, November 1, 1977, and concluding on Wednesday, March 1, 1978, consisting of Volume AA, 81 pages; Volume A, 95 pages; Volume B, 130 pages; Volume C, 113 pages; Volume D, 144 pages; and Volumes 1 through 77, 12,002 pages; and that these pages represent a true, correct and complete transcript of the those proceedings.

/s/ Joan M. Unzicker
Joan M. Unzicker,
Official Court Reporter.

FILED
FEB 25 1980
MICHAEL RODAK, JR., CLERK

No. 79-1154

In the Supreme Court of the United States

OCTOBER TERM, 1979

ANTHONY COLAO, ROY V. JOHNSON, MORRIS I. GINSBURG, PAUL J. MILLER, WILLIAM A. F. SMITH, GEORGE R. CABLE and HAROLD J. SEXTON,

Petitioners,

vs.

MERIT INSURANCE COMPANY, INC.,
an Illinois Corporation,

Respondent.

RESPONSE TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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In the Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-1154

ANTHONY COLAO, ROY V. JOHNSON, MORRIS I. GINSBURG, PAUL J. MILLER, WILLIAM A. F. SMITH, GEORGE R. CABLE and HAROLD J. SEXTON,

Petitioners,

VS.

MERIT INSURANCE COMPANY, INC., an Illinois Corporation,

Respondent.

RESPONSE TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Questions Presented

1. Did the Court of Appeals properly apply Rule 8 of the Federal Rules of Civil Procedure in not requiring the plaintiff in a diversity action to allege freedom from contributory negligence in pleading a negligence claim?

2. Did the Court of Appeals correctly determine that the plaintiff's complaint stated a cause of action against accountants for negligence under Illinois Law?

3. Did the Court of Appeals properly find that the evidence presented by plaintiff at trial established a prima facie case of fraud against the defendant accountants, so that reversal of the District Court's directed verdict in favor of the defendants was proper?

Statement of the Case

This is a diversity action involving allegations of common law fraud and negligence by accountants. The plaintiff is respondent Merit Insurance Company; the defendants, petitioners, are the partners and certain employees of Joseph Froggatt & Co., an accounting firm. Respondent alleges (1) that petitioners prepared and issued audited financial statements for an insurance agency, General Auto Placement, Inc. ("GAP"), (2) that the audit report contained several serious misstatements and omissions, and (3) that respondent relied on the audit report, to its detriment, in deciding to do business with GAP. Respondent alleged negligence and fraud by petitioners in alternative counts. The negligence count was dismissed before trial, and the case was tried only on the fraud count.

The trial was conducted before Senior District Judge Julius J. Hoffman sitting with a jury. Respondent presented its case for four months, from November 1, 1977 until February 28, 1978. During this time, Judge Hoffman excluded a large volume of the evidence introduced by respondent. With few exceptions, he sustained all of the evidentiary objections made by petitioners. No documents were admitted to which petitioners made objections. Hundreds of offers of proof were made; not once did Judge Hoffman reverse his previous ruling to permit the offered evidence to be admitted. At the end of four months, Judge Hoffman directed a verdict in favor of petitioners.

Respondent appealed to the Court of Appeals for the Seventh Circuit. The Court of Appeals reversed and remanded for a new trial before a judge of the District Court other than Judge Hoffman.

After reviewing the evidence, the Court of Appeals found that "despite the fact that much relevant evidence was not admitted" by Judge Hoffman, respondent nevertheless "presented sufficient evidence to establish a *prima facie* case of fraud . . . ." (Pet., p. 7a.) Because the court remanded for a new trial, it decided that "no purpose would be served in further marshalling" the erroneously excluded evidence. (*Id.*, p. 8a.) The court also reversed Judge Hoffman's dismissal of the negligence count. The petition for certiorari followed.

REASONS FOR DENYING THE WRIT OF CERTIORARI

Petitioners argue three points, none of which approaches the kind of important constitutional or policy question which this Court should exercise its discretion to hear.

I.

The Court of Appeals Correctly Recognized That Rule 8 Governs Pleadings in Federal Diversity Actions And That State Law Governs Burdens of Proof.

Petitioners first argue that the Court of Appeals "Created A Substantive Right . . . Which Is In Conflict With The Rule Of Law Set Down By This Court In Erie R. Co. v. Tompkins." (Pet., p. 5.) The basis for the argument is the Court of Appeals' reversal of Judge Hoffman's dismissal of Count I of the complaint. Count I stated a claim for negligence against petitioners but did not allege respondent's freedom from contributory negligence. Petitioners claim that the requirement of Illinois law that a plaintiff plead freedom from contributory negligence requires dismissal of the count for failure to state a cause of action.

The fallacy of the argument is its failure to recognize the distinction between pleading and proving contributory negligence. This distinction was recognized by this Court in *Palmer* v. *Hoffman,* 318 U.S. 109 (1943), the very case that petitioners cite in their petition. (Pet., p. 6.) The plaintiff there argued that the defendant had the burden of proving contributory negligence because Rule 8(c) of the Federal Rules of Civil Procedure made contributory negligence an affirmative defense. In response to the argument this Court stated:

> "We do not agree. Rule 8(c) covers only the manner of pleading. The question of the burden of establishing contributory negligence is a question of local law which federal courts in diversity of citizenship cases [citing *Erie*] must apply." 318 U.S. at 117.

The case clearly establishes the principle that the Federal Rules determine the sufficiency of pleadings while state law allocates burdens of proof in diversity cases. The sufficiency of a plaintiff's pleading is governed by Rule 8(a), which requires simply (1) a jurisdictional statement, (2) "a short and plain statement of the claim showing that the pleader is entitled to relief," and (3) a demand for judgment.

The case of *Francis* v. *Humphrey,* 25 F.Supp. 1 (E.D. Ill. 1938), cited by petitioners (pet., p. 6), is to the contrary but is out of date. It was decided at a time when "the burden of pleading was inextricably intertwined with the burden of proof so that the party having the burden of pleading a certain matter likewise had the ultimate burden of proving it." *Gilmore* v. *Witschorek,* 411 F. Supp. 491, 495 (E.D. Ill. 1976). After the decision in *Francis* v. *Humphrey,* this Court in *Palmer* made it clear that the burden of pleading and the burden of proof are controlled by different rules, and at least two federal courts have since rejected the earlier holding. *Gilmore* v. *Witschorek, supra; Klondike Helicopters, Ltd.* v. *Fairchild Hiller Corp.,* 334 F.Supp. 890, 896 (N.D. Ill. 1971).

The case of *Sundstrand Corp.* v. *Standard Kollsman Industries, Inc.,* 488 F.2d 807, 813 (7th Cir. 1973), also cited by petitioners (pet., p. 10), is not to the contrary. It holds, significantly, that (1) burden of proof is a matter of substantive law to be decided by application of local law under the *Erie* doctrine, and (2) a defendant needs to plead affirmatively under Rule 8(c) only those defenses for which he bears the burden of proof. The case gives no consideration to what a plaintiff must plead. The remain-

ing authorities cited by petitioners are cases decided under the *Erie* doctrine and have little relevance to the issue raised here.

Finally, while petitioners emphasize that the Court of Appeals panel was not unanimous in its reversal of Judge Hoffman, they neglect to point out that all the judges below were unanimous in rejecting petitioners' first and lengthiest argument for granting their petition. Judge Harlington Wood, the dissenting judge in the Court of Appeals, stated categorically that "plaintiff need not allege due care" in its complaint for negligence. (Pet., p. 20a.) And, while Judge Hoffman in the District Court dismissed Count I on other grounds, he too held:

> "The drafters of the Federal Rule have provided members of the Federal Bar with sample forms to be considered as examples of notice pleading. Form 9 indicates the brevity with which negligence is to be alleged. It is not within the contemplation of those authors to dismiss a negligence count for failure to allege the exercise of due care and caution on the part of the plaintiff." Tr. of Proceedings, April 8, 1977, p. 15 (see appendix p. 2).

Had failure to allege absence of contributory negligence been the basis for dismissal of Count I, respondent would simply have amended its complaint.

II.

In Reversing Dismissal Of The Negligence Count, The Court Of Appeals Correctly Anticipated Illinois Law In The Area of Negligent Misrepresentations.

Petitioners' second argument is that the Court of Appeals erred in reversing the dismissal of Count I because an action against accountants for negligence has never been considered or authorized by Illinois courts. Petitioners also contend that "every indication" suggests that Illinois courts would not permit such an action, although the only Illinois case they cite is the same one relied upon by the Court of Appeals. (Pet., p. 12.) Both points fall far short of constitutional significance; neither is a matter of material significance.

Where state courts have not decided an issue raised before a federal court sitting in diversity jurisdiction, the federal court is required, not to abstain, but to predict how those state courts would decide the issue when presented with it. *Bernhardt* v. *Polygraphic Co. of America,* 350 U.S. 198, 209-212 (1956) (Frankfurter, J., concurring); *Holt* v. *Seversky Electronatom Corp.,* 452 F.2d 31, 34 (2d Cir. 1971). In doing so, the federal court may reasonably extend the case authorities that appear to effectuate the current policies of the state. See *Bowen* v. *United States,* 570 F.2d 1311, 1322 (7th Cir. 1978). The fact that Illinois courts had not specifically considered whether accountants may be held liable for negligence was thus clearly no bar to the decision of the Court of Appeals.

As the Court of Appeals recognized, *Rozny* v. *Marnul,* 43 Ill.2d 54, 250 N.E.2d 656 (1969), is the "controlling authority" in Illinois in the area of negligent misrepresentations. (Pet., p. 9a.) *Rozny* dealt with the liability of a land surveyor rather than an accountant, but the Illinois Supreme Court there referred to and reasoned from cases in which an accountant was held subject to liability for negligence. See *Rusch Factors, Inc.* v. *Levin,* 284 F.Supp. 85 (D.R.I. 1968), and *Fischer* v. *Kletz,* 266 F.Supp. 180 (S.D.N.Y. 1967), cited in *Rozny,* 43 Ill.2d at 67, 250 N.E.2d at 663. The Illinois Supreme Court in *Rozny* held the defendant surveyor liable for negligent misrepresentation to plaintiff homeowners who eventually acquired the parcel of land surveyed by the defendant. In doing so the court re-

jected the old common law requirement of a contractual relationship in a case alleging negligent misrepresentation, stating that "tort liability will henceforth be measured by the scope of the duty owed rather than the artificial concepts of privity." 43 Ill.2d at 62, 250 N.E.2d at 660.

The primary issue before the Court of Appeals was not, as petitioners suggest, whether accountants could be held liable under the reasoning of *Rozny*. Clearly they could. Rather, the issue was whether the facts alleged in respondent's complaint brought the case within *Rozny's* requirement that liability for a negligent misrepresentation be limited "to a comparatively small group, and that, ordinarily, only one member of that group will suffer loss. . . ." 43 Ill.2d at 67, 250 N.E.2d at 663. The Court of Appeals held that the complaint, liberally construed under Rule 8(a), sufficiently alleged that petitioners knew that a limited class might rely on the audit report. (Pet., p. 10a.)

Should this Court grant the petition for certiorari, it will again be faced with the question of the sufficiency of the complaint's allegations under *Rozny*. We submit that the Court of Appeals' decision was manifestly correct. The issue is not the kind of important state or federal question that needs to be decided by this Court, especially when the case has been remanded for a new trial.

III.

The Court of Appeals Correctly Determined That The Evidence At Trial Established A Prima Facie Case Of Fraud.

For their third argument petitioners abandon all pretense of formulating an appropriate issue upon which to base the granting of their petition and ask this Court to review the transcript covering a 17 week trial in order to

determine whether the Court of Appeals was correct in concluding that respondent presented a prima facie case of fraud. Specifically, petitioners contend that respondent failed to establish (1) that it had a "right to rely" on petitioner's audit report or (2) that its damages were not caused by the fraud of some third parties. (Pet., pp. 15-16.)

This response is not the proper place for an extensive review of the evidence on respondent's right to rely or the cause of its damages. Nor is the Supreme Court of the United States the proper forum in which such a review should be made. Suffice it to say that, as to reliance, respondent's president testified that the audit report induced him to follow through with GAP, that he was particularly impressed with the "clean opinion" given by petitioners, and that petitioners were a well-known accounting firm in the insurance field. This testimony, as held by the Court of Appeals, created a jury question as to whether respondent was justified in relying on the audit report. (Pet., p. 18a.) The audit report, moreover, was not 16 months old when respondent first received it, as petitioners contend. (Pet., p. 16.) The report was dated July 15, 1971, and respondent received it in April of 1972. It was the most current certified financial information available for GAP, and it fraudulently misrepresented the financial condition of GAP for the time period covered by the audit.

As to damages, Judge Hoffman refused to permit any evidence until, in his view, respondent established liability. Because he found that liability was never established, he gave respondent no opportunity to submit evidence on damages and causation. Petitioners' argument on the cause of respondent's losses is thus hypothetical and misleading. The fraudulent conduct of third parties will not, in any event, excuse petitioners' own fraud, as petitioners seem to suggest. *McRoberts* v. *Combination Fountain Co.*, 317 Ill. 165, 170-171, 147 N.E. 785, 787 (1925); Prosser, *Law of Torts* 715 (4th ed. 1971).

CONCLUSION

The issues raised by the petition are plainly without merit. The petition should be denied forthwith.

Respectfully submitted,

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Dated: February 25, 1980

APPENDIX

APPENDIX

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 75 C 899

MERIT INSURANCE COMPANY,

Plaintiff,

vs.

ANTHONY COLAO, et al.,

Defendants.

TRANSCRIPT OF PROCEEDINGS

had in the above-entitled cause before the HON. JULIUS J. HOFFMAN, one of the Judges of said Court, in his courtroom in the United States Courthouse, Chicago, Illinois, on Friday, April 8, 1977, at the hour of 10:00 o'clock a.m.

* * *

We come now to the consideration of Counts I and II alleging a cause of action based upon the negligence—rather the negligent preparation of financial statements by the Froggatt firm. Count II contains similar factual allegations, but alleges "gross negligence" on the part of Froggatt.

The defendants seek dismissal of both counts for a variety of reasons. The counts are initially challenged for failure to specifically plead the plaintiff's exercise of due care. Under the laws of the State of Illinois, a plaintiff must plead and prove exercise of due care and caution at the time of the incident in question. Faber v. General Telephone Co. of Illinois, 19 Il.App.3d 135, 311 N.E.2d 281 (1974); Kray v. Ricci, 14 Il.App.3d 904, 303 N.E.2d 458 (1973).

However, under the Federal Rules of Civil Procedure there is no requirement that negligence be alleged with specificity. Although the substantive law of the State of Illinois must govern this action, the rigid requirements pleading facts utilized by the State's judicial system is not thereby incorporated.

The drafters of the Federal Rule have provided members of the Federal Bar with sample forms to be considered as examples of notice pleading. Form 9 indicates the brevity with which negligence is to be alleged. It is not within the contemplation of those authors to dismiss a negligence count for failure to allege the exercise of due care and caution on the part of the plaintiff.

The defendants similarly contend that the plaintiff has failed to allege facts showing a right to rely on the financial statements at issue.

Unlike a cause of action for fraud, justifiable reliance is not an element which must be proved to recover under a negligence theory. While evidence of the age of the financial statements might be admissible on the issue of contributory negligence, age is not a basis for dismissal of these counts.

The primary substantive contention raised by the parties relates to the question of the duty owed by Froggatt

to the plaintiff. As this issue is before the District Court pursuant to its diversity jurisdiction, the scope of duty is to be measured by reference to the laws of the State of Illinois. While the courts of several states have addressed this issue, the Illinois Supreme Court has not been called upon to consider the extent of an accountant's professional liability. Thus, the Court must decide this issue as it believes the Illinois courts would rule upon it. Walker v. Kruse, 484 F.2d 802, Seventh Circuit (1973).

As Justice Frankfurter observed in Bernhardt v. Polygraphic Company of America, Inc., 350 U.S. 198, 209:

> "As long as there is diversity jurisdiction, estimates are necessarily often—necessarily often all that the federal courts can make in ascertaining what the state court would rule to be its law."

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